

2001 ANNUAL REPORT

PETRO-REEF RESOURCES LTD.

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Canada

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President's Message and Management Discussion

During the 2001 fiscal year and to the end of March 2002 the company drilled ten (10) wells of which seven (7) were completed as gaswells and three (3) wells were dry and abandoned, for a 70.0% success ratio. Four (4) of these wells were placed on stream as gaswells, with one (1) well being suspended before year-end and awaiting re-completion. Three (3) other wells are currently being tied-in or awaiting tie-in in the next sixty to ninety days.

On October 9, 2001 the company entered into an operating line of credit with the National Bank of Canada. The credit facility is in the form of a revolving operating demand loan with a maximum limit of one million (\$1,000,000.00) dollars and a non-revolving acquisition demand loan with a maximum limit of one-half million (\$500,000.00) dollars.

The company has continued to expand its core area of operations and increased its land position from 22,240 gross acres to approximately 25,000 gross acres (an 11% increase) with working interest net to Petro-Reef varying from 17.27% to 90.0%.

Following are the corporate review highlights for fiscal year 2001.

Total BOE (@ 6:1) Production for 2001	29,426 BOE
Operating Cost per BOE	\$ 3.61
Crown and Freehold Royalty Expense per BOE	\$ 3.95
General and Administrative Cost per BOE	\$ 8.36
Cash Flow per BOE	\$15.74

Recycle Ratio (Cash Flow / Finding & Development Cost) 3.48:1 (3 year average)

Reserve Life Index (per independent engineering evaluation) Proven Reserves only 22 years.

Reserve Replacement Ratio (Reserve Additions / 2001 Production) 4.25:1

Investing Activities for 2001 (Net) (Oil & Natural Gas Properties Only)

Land Acquisition	\$ 12,038.00
Drilling Cost	\$539,340.00
Completion Cost	\$148,246.00
Production Facilities	\$181,329.00
Workovers	\$ 43,345.00
Geological & Geophysical	\$ 26,857.00
Total:	<u>\$951,155.00</u>

Reserves (Proven only) Net to Petro-Reef (January 1, 2002) 2072.0 MMCF + 8.9 Mbbls.
354,233 BOE

Value @ Undiscounted (M\$) (@\$3.88 / MCF)	<u>\$7,010.2</u>
@ 10% discount of future cash flow (M\$)	<u>\$4,599.0</u>
Net Reserves to Petro-Reef are 97.5% natural gas.	

Review of Properties and Plans for 2002

Exploration Criteria

The company continues to use the following exploration criteria on each prospective area, to assure high profitability and rate of return on capital investment:

- 1) Each exploration prospect must exhibit
 - a) A minimum three (3) hydrocarbon zone potential.
 - b) Each zone must show the potential for:
 - (i) 10:1 profit to capital risk ratio
 - (ii) a minimum of 30% rate of return on capital invested.
 - (iii) minimum life of 15 years.
- 2) The use of 2-D and 3-D seismic to identify and confirm potential drilling locations including state-of-the-art seismic imaging technology.

Review of Properties

1) Peavey / Morinville, Alberta Land, Exploration, and Development

The company presently owns an average 30.8% working interest, after payout of certain earning wells by an industry partner, in approximately 15,520 gross acres of land. There are nine (9) producing gas wells, six (6) capped gaswells, and five (5) suspended wells. Petro-Reef is operator on approximately 25% of the property.

Fiscal year 2001 saw seven (7) wells drilled on the Peavey / Morinville Prospect. The 2001 drilling program resulted in five (5) potential gaswells and two (2) abandoned wells for a 71.4% success ratio. Of the five (5) completed wells two (2) have been tied-in. The other three (3) wells are awaiting evaluation and / or tie-in together with three (3) other wells drilled in the previous years. Of the five (5) suspended wells, three (3) wells are currently undergoing re-evaluation as potential re-completion in other zones and the other two (2) wells will in all likelihood be abandoned. Of the eleven (11) wells capped and / or suspended Petro-Reef is Operator on one (1) well.

Production comparison for the last quarter of fiscal year 2000 versus the last quarter of fiscal year 2001 for the Peavey / Morinville property is 3778 BOE (42 BOE / day) versus 7839 BOE (87 BOE / day)

Activity for 2002

Pressure depletion together with connate water influx has caused the Operator to swab test four (4) of six (6) producing wells. Remedial work is anticipated on these wells to improve production rates. Petro-Reef as Operator on one (1) well has swab tested said well and improved production by 425% from 125 MCF/D (21 BOE / day) to 525MCF/D (87.5 BOE / day).

Capital expenditures for 2002 include remedial work on four (4) wells, the drilling of one (1) well, and the tie-in of five (5) wells for a total capital investment of approximately \$218,000.00.

2) Deadman / Alexander / Oui Barre, Alberta
Land, Exploration and Development

The company has increased its land position in the Deadman / Alexander / Oui Barre property in fiscal 2001 from 3520 to 6329 gross acres with an average working interest of approximately 32%.

Two (2) wells were drilled during fiscal year 2001 which resulted in one (1) completed gaswell and one (1) abandoned well. Both wells were drilled by an industry partner at no cost to the company on a one section farm-in where Petro-Reef retained a fifteen (15%) percent gross overriding royalty till payout at which time the company's interest reverts to a 50.0% working interest.

In December, 2001 the company entered into a second farmout agreement with an industry partner whereby the partner has agreed to carry Petro-Reef through the drilling and completion cost on three (3) wells to earn fifty (50%) percent of Petro-Reef's working interest. The average 32% working interest is after the farmout. Petro-Reef is the Operator.

Activity for 2002

In February, 2002 Petro-Reef drilled the first of the three farmout wells and completed same as a 1.5 MMCF/D (250 BOE/D) gaswell. The first gas well drilled in fiscal year 2001 was placed on stream in March, 2002 at 500 MCF/D (83.3 BOE/D). The gaswell drilled in February, 2002, is currently being tied-in and is anticipated to be on stream by the end of May, 2002 at the aforementioned rate. Net production to Petro-Reef by the end of May, 2002 should be 677 MCF/D (113 BOE/D).

Two (2) more earning wells, under the farmout agreement, will be drilled in the next Thirty (30) to sixty (60) days with a third well planned for the fourth quarter of 2002.

Capital expenditures net to Petro-Reef for 2002 for this property are approximately:

Drilling & Completion	\$221,000.00
Tie-Ins	\$242,000.00
Seismic	<u>\$ 28,000.00</u>
Total Capital Expenditure =	<u>\$491,000.00</u>

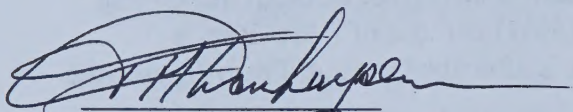
Total Capital Budget (Fiscal Year 2002)

Total Capital Budget for 2002 (All properties) is:

Drilling & Completion	\$221,000.00
Tie-Ins	\$470,000.00
Seismic	\$ 46,000.00
General and Administrative	\$384,000.00
Land	\$140,000.00
F 2002 Total Budget =	<u>\$1,261,000.00</u>

On behalf of Petro-Reef and the board of directors, I would like to thank the shareholders for their continued support. We will continue to endeavor to meet and hopefully exceed your expectations in what has started as an exciting first part of fiscal year 2002.

Dated May 10, 2002



"Ted M. Donhuysen"

President & C.E.O.

**PETRO-REEF RESOURCES LTD.
CORPORATION INFORMATION**

Directors and Officers

Theodore M. Donhuysen

Chief Executive Officer
President & Director
Calgary, Alberta

Joseph Werner

Chairman of the Board
Chief Financial Officer & Director
Calgary, Alberta

Robert N. Maertens-Poole

Director
Calgary, Alberta

John Lagadin

Director
Calgary, Alberta

Alan P. Hallman

Director
Calgary, Alberta

R. Greg Powers

Legal Council and
Corporate Secretary

Dennis K. Ulrich

Assistant Secretary

Rosa Donhuysen

Comptroller

Head Office

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petroreef@shawcable.com

Bank

National Bank of Canada

Auditors

PricewaterhouseCoopers LLP
Chartered Accountants

Registrar and Transfer Agent

CIBC Mellon Trust Company

Stock Listing

TSX Venture Exchange
Symbol PER

Revenue	1,000,000
Cost of sales	(500,000)
Gross profit	500,000
Operating expenses	(200,000)
Operating income	300,000
Interest income	100,000
Interest expense	(50,000)
Income before taxes	350,000
Income taxes	(100,000)
Net income	250,000

Net income per share

Basic and diluted net income per share

Weighted average

Number of shares

Petro-Ref Resources Ltd.

Financial Statements

For the years ended 31, 2001 and 2000

The accompanying financial statements were prepared by management of Petro-Ref Resources Ltd. and are not audited. The financial statements are prepared in accordance with the accounting policies of the company and are not intended to be a substitute for an audit by a chartered accountant.

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April 10, 2002

Auditors' Report

To the Shareholders of
Petro-Reef Resources Ltd.

We have audited the balance sheets of **Petro-Reef Resources Ltd.** as at December 31, 2001 and 2000 and the statements of earnings and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2001 and 2000 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

Petro-Reef Resources Ltd.

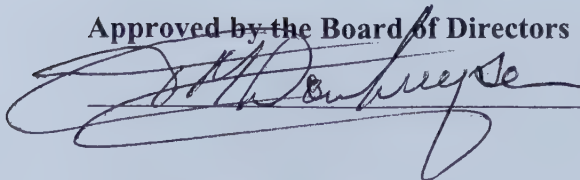
Balance Sheets

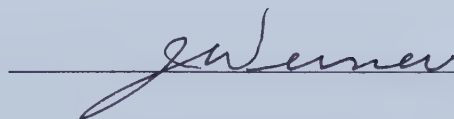
As at December 31, 2001 and 2000

	2001 \$	2000 \$
Assets		
Current assets		
Cash and short-term investments	271,334	224,749
Accounts receivable	437,073	514,602
Prepaid expenses and deposits	59,457	48,787
	<u>767,864</u>	<u>788,138</u>
Property, plant and equipment (note 2)	5,643,115	5,020,227
	<u>6,410,979</u>	<u>5,808,365</u>
Liabilities		
Current liabilities		
Accounts payable and accrued charges	1,072,335	594,793
Future site restoration	29,392	17,705
Future income taxes (note 4)	887,878	882,556
	<u>1,989,605</u>	<u>1,495,054</u>
Shareholders' Equity		
Capital stock (note 3)	4,694,176	4,694,176
Deficit	(272,802)	(380,865)
	<u>4,421,374</u>	<u>4,313,311</u>
	<u>6,410,979</u>	<u>5,808,365</u>

The accompanying notes are integral to the financial statements.

Approved by the Board of Directors

 Director

 Director

Petro-Reef Resources Ltd.

Statements of Earnings and Deficit

For the years ended December 31, 2001 and 2000

	2001 \$	2000 \$
Revenue		
Oil and gas sales, net of royalties and ARTC	815,592	922,804
Overhead recoveries	106,373	41,774
Interest income	11,977	8,501
	<u>933,942</u>	<u>973,079</u>
Expenses		
Production	106,160	141,824
General and administrative	364,498	305,533
Depletion, depreciation and amortization	349,899	327,211
	<u>820,557</u>	<u>774,568</u>
Earnings before the following	113,385	198,511
Future income taxes (note 4)	<u>5,322</u>	<u>82,410</u>
Net earnings for the year	108,063	116,101
Deficit – Beginning of year	(380,865)	(7,953)
Adjustment due to change in accounting policy (note 4)	<u>-</u>	<u>(489,013)</u>
Deficit – End of year	<u>(272,802)</u>	<u>(380,865)</u>
Basic and diluted earnings per common share	<u>0.01</u>	<u>0.01</u>

The accompanying notes are integral to the financial statements.

Petro-Reef Resources Ltd.

Statements of Cash Flows

For the years ended December 31, 2001 and 2000

	2001 \$	2000 \$
Cash provided by (used in)		
Operating activities		
Net earnings for the year	108,063	116,101
Items not affecting working capital		
Depletion, depreciation and amortization	349,899	327,211
Future income taxes	5,322	82,410
Cash flow from operations	463,284	525,722
Net change in non-cash operating working capital items	98,690	(453,766)
	561,974	71,956
Financing activity		
Issuance of common shares	-	269,700
Investing activities		
Expenditures on property, plant and equipment	(961,100)	(658,129)
Net change in non-cash investing working capital items	445,711	236,827
	(515,389)	(421,302)
Change in cash and short-term investments during the year	46,585	(79,646)
Cash and short-term investments – Beginning of year	224,749	304,395
Cash and short-term investments – End of year	271,334	224,749
Basic and diluted cash flow per share	0.03	0.03

The accompanying notes are integral to the financial statements.

Petro-Reef Resources Ltd.

Notes to Financial Statements

December 31, 2001 and 2000

1 Accounting policies

Oil and gas operations

The company is engaged in the exploration for and production of oil and natural gas in Canada.

The company follows the full cost method of accounting for oil and gas operations whereby all costs related to the acquisition of, exploration for and development of oil and gas reserves are capitalized. Such costs include leasehold acquisition costs, geological and geophysical costs, lease rentals, drilling, plant and equipment costs and related overhead. Government incentives are credited to the cost of the oil and gas properties at the time the expenditures are incurred. Proceeds from the disposal of properties are applied as a reduction of the cost of the remaining assets with no gain or loss recognized, unless such a sale would result in a change of more than twenty percent in the depletion rate.

In applying the full cost method, the company calculates a cost ceiling which restricts the capitalized costs less accumulated depletion from exceeding the estimated future net revenue from proved reserves, based on current prices and production costs plus the net cost of undeveloped acreage, less future general and administrative expenses, financing costs, site restoration costs and income taxes.

Depletion is computed using the unit-of-production method based on gross estimated proved oil and gas reserves (converted to equivalent units on the basis of estimated relative energy content). In determining the appropriate depletion rate, the company includes the net book value of its proved oil and gas properties, as well as the estimated future costs to be incurred in developing proved reserves excludes the unimpaired cost attributable to unproved properties.

Estimated costs of future abandonment and restoration of well sites and associated facilities are amortized over the life of the properties on a unit-of-production basis.

Depreciation

Depreciation of furniture and fixtures is calculated using the declining balance method at an annual rate of 20%.

Stock options

The company does not record any compensation expense in respect of stock options granted to directors, officers and employees. The consideration paid by holders of the options upon exercise is credited to share capital.

Petro-Reef Resources Ltd.

Notes to Financial Statements

December 31, 2001 and 2000

Earnings per share

Effective January 1, 2001, the company adopted the Canadian Institute of Chartered Accountants' new accounting standard with respect to the calculation and disclosure of per share amounts. Under the new standard, the treasury stock method of calculating per share amounts is used whereby any proceeds from the exercise of stock options or other dilutive instruments are assumed to be used to purchase common shares at the average market price during the period.

The adoption of the new accounting standard has had no material effect on the diluted earnings per share of current and prior periods.

Joint ventures

Substantially all of the company's activities are conducted jointly with other industry partners and accordingly, these financial statements reflect only the company's proportionate interest in such activities.

2 Property, plant and equipment

	2001		
	Cost \$	Accumulated depletion and depreciation \$	Net \$
Petroleum and natural gas	7,607,677	1,976,947	5,630,730
Furniture and fixtures	25,462	13,077	12,385
	<u>7,633,139</u>	<u>1,990,024</u>	<u>5,643,115</u>
	2000		
	Cost \$	Accumulated depletion and depreciation \$	Net \$
Petroleum and natural gas	6,655,522	1,640,981	5,014,541
Furniture and fixtures	16,517	10,831	5,686
	<u>6,672,039</u>	<u>1,651,812</u>	<u>5,020,227</u>

No interest or general and administrative expenses were capitalized during the year.

Petro-Reef Resources Ltd.

Notes to Financial Statements

December 31, 2001 and 2000

Unproven property costs of \$302,652 (2000 – \$740,978) have been excluded from capitalized costs subject to depletion.

Due to significant price fluctuations during the year, the ceiling test calculation used the annual average price of \$31.17/bbl for oil and \$5.26/mcf for gas. Had the company's average December realized prices of \$31.31/bbl for oil and \$3.50/mcf for gas been used, an asset write-down of \$1.4 million would have been required.

3 Capital stock

The authorized share capital of the company is comprised of an unlimited number of preferred shares and an unlimited number of common shares. Details of the changes in the company's share capital during 2001 and 2000 are as follows:

	<u>2001</u>		<u>2000</u>	
	Number of shares	Amount \$	Number of shares	Amount \$
Common shares				
Balance – Beginning of year	17,588,937	4,694,176	16,688,937	4,424,476
Issued for the exercise of stock options	-	-	900,000	269,700
Balance – End of year	<u>17,588,937</u>	<u>4,694,176</u>	<u>17,588,937</u>	<u>4,694,176</u>

Earnings per common share are calculated using the weighted average number of common shares outstanding during the year of 17,588,937 (2000 – 16,713,594).

Petro-Reef Resources Ltd.

Notes to Financial Statements

December 31, 2001 and 2000

Stock options

The company has a stock option plan for directors, officers and key employees. The exercise price of each option equals the market price of the company's stock on the date of grant. Options are fully vested at the date of grant and expire after a maximum exercise period of three years from the date of issuance. As at the date hereof, there are a total of 1,250,000 options granted under the stock option plan outstanding as follows:

	2001		2000	
	Shares	Weighted-average exercise price \$	Shares	Weighted-average exercise price \$
Outstanding – Beginning of year	1,100,000	0.70	1,222,000	0.37
Granted	350,000	0.49	900,000	0.71
Exercised	-	-	(900,000)	0.29
Expired	(200,000)	0.60	(122,000)	0.60
Options exercisable at year end	1,250,000		1,100,000	

The following table summarizes information about fixed stock options outstanding at December 31, 2001:

	Options outstanding			Options exercisable	
Range of Exercise price	Number outstanding	Weighted-average remaining contractual life	Weighted-average exercise price (\$/share)	Number exercisable	Weighted-average exercise price (\$/share)
\$0.49 – \$0.50	450,000	2.24 years	0.49	450,000	0.49
\$0.75 – \$0.80	800,000	0.98 years	0.76	800,000	0.76
	1,250,000	1.43 years	0.66	1,250,000	0.66

Petro-Reef Resources Ltd.

Notes to Financial Statements

December 31, 2001 and 2000

4 Income taxes

Effective January 1, 2000, the company adopted the Canadian Institute of Chartered Accountants' new accounting standard with respect to accounting for income taxes. The new standard recommends the liability method of determining income taxes where future income taxes are determined based on temporary differences between the tax bases of assets and liabilities and their carrying amounts. Previously, the company used the deferral method of determining income taxes where deferred income taxes were recognized based on the differences in timing of recognition of revenue and expenses for financial accounting and income tax purposes. The new standard was applied retroactively without restatement of prior periods.

The effects of the new standard on the opening balances of the 2000 financial statements that were reported in the financial statements of that year were:

	\$
Increase deficit	601,530
Increase property, plant and equipment	311,133
Increase future income tax liabilities	<u>(912,663)</u>
	<u>-</u>

Based on final tax pool and loss carryforward information obtained relating to a 1999 acquisition, the accounting for the adoption of the new standard has been revised as follows:

	\$
Increase deficit	489,013
Increase property, plant and equipment	311,133
Increase future income tax liabilities	<u>(800,146)</u>
	<u>-</u>

The following table summarizes the temporary differences which give rise to the future income tax liability at December 31, 2001:

	\$
Future income tax liabilities	
Property, plant and equipment	907,468
Future income tax assets	
Site restoration	(12,527)
Share issue costs	<u>(7,063)</u>
	<u>887,878</u>

Petro-Reef Resources Ltd.

Notes to Financial Statements

December 31, 2001 and 2000

At December 31, 2001, the company has successor tax pools of approximately \$825,000 available for deduction from future taxable income. These successor pools have not been recognized for purposes of the future tax calculation due to the uncertainty as to whether sufficient revenue will be realized from the related properties to utilize the pools.

The income tax provision differs from the amount computed by applying the expected income tax rate of 43.12% (2000 – 44.62%) to earnings before taxes. The reasons for this difference are as follows:

	2001 \$	2000 \$
Earnings before taxes	113,385	198,511
Effective tax rate	43.12%	44.62%
Expected tax expense at combined federal and provincial rates	48,892	88,576
Crown royalties and production taxes	52,777	91,576
Alberta royalty tax credit	(13,160)	(23,654)
Crown lease rentals	-	(888)
Resource allowance	(46,711)	(75,600)
Decrease in future taxes due to tax rate reduction	(37,878)	-
Other	1,402	2,400
	5,322	82,410

5 Commitments

The present office lease agreement expires on August 31, 2003. Future lease payments over the next year (2002) under the company's office lease will total \$42,032. The lease payments for 2003 will total \$28,021.

6 Financial instruments

Financial instruments include cash and short-term investments, accounts receivable, and accounts payable and accrued charges. At December 31, 2001, the fair market value of the financial instruments approximated their carrying value due to the short-term maturity of these instruments.

